FDIC Deposit Insurance Symposium

The current debate in the United States over financial modernization has been accompanied by numerous calls for further reform of the deposit insurance system. This discussion of deposit insurance reform, which focuses for the most part on regulatory burden, takes place at a time when our banking industry is experiencing an extraordinary resurgence from the crisis of the 1980s and early 1990s.

On January 29, 1998, the FDIC sponsored a symposium to promote a deliberate and fully informed discussion of the role and nature of deposit insurance. The audience of over one hundred included bankers, regulators, consumer and trade group representatives, academics, and congressional staff members. Many of the complex issues associated with maintaining an effective deposit insurance system were explored in four panel discussions.

Financial Modernization

Financial markets and depository institutions have changed dramatically since the United States established federal deposit insurance in the 1930s. Innovations in technology and information services have allowed financial service providers to offer a full range of products, blurring the distinction between banking and nonbanking organizations. A number of proposals have been advanced relating to expanding the range of activities permissible for banking organizations. The FDIC generally has supported these initiatives, to the extent that the expanded activities would pose no significant safety-and-soundness concerns

Panelists addressed the possibility that expansion of bank activities could increase the exposure of the deposit insurance system and, more generally, the government safety net. They expressed concern that the additional costs associated with expansion of the safety net -- both to the industry and to regulators -- could be greater than the additional benefits. Given that there appears to be little public support for scaling back the safety net, and that a reduced safety net may not provide a credible guarantee of stability in times of severe financial stress, some panelists expressed the view that financial modernization is unlikely to prompt significant deposit insurance reform.

Other participants discussed the issue of what safeguards or firewalls are necessary to protect the insurance funds from undue risk and minimize potential market distortions associated with federal involvement in deposit insurance. Central to this discussion was the question of whether a bank subsidiary or holding company affiliate structure would be more effective for implementing and maintaining such safeguards.

Reform Proposals

Schemes have been proposed that would radically change the present deposit insurance system. A number of reform proponents were afforded the opportunity to present their ideas at the FDIC symposium. While all of these individuals called for change, they disagreed as to the nature of the alleged deficiencies in the present system.

One set of proposals would retain the FDIC's basic form, but transfer its ownership to insured institutions, away from the federal government. In addition, the government's full faith and credit guarantee of insured deposits and the so-called "too-big-to-fail" doctrine would be abolished in order to introduce more market discipline. Another privatization proposal would require every bank to enter into a contract with a syndicate of voluntary guarantors – largely other banks – that would guarantee the original contractual terms of all deposits and most other liabilities of the guaranteed institution.

These and similar proposals seemed to lack general support among the industry observers in attendance. It was apparent from comments made during the panel discussion that many observers have serious concerns regarding the ability of a privatized deposit insurance system to guarantee the availability of enough resources to maintain stability in times of severe financial stress. It also was not clear to many that eliminating the federal role in the deposit insurance system would significantly reduce regulatory burden.

Panelists discussed the fact that deposit insurance was debated at length and reformed less than a decade ago with FDICIA. The focus then was on moral hazard, and the reform was designed to control excessive risk-taking in order to protect the insurance funds and ultimately the taxpayer. Reform measures included prompt corrective action, least cost resolution, the systemic risk exception, risk-related premiums, and depositor preference. Given that these measures constitute significant deposit insurance reform that has not yet been tested in difficult times, several participants suggested that it would be premature to initiate additional, major reforms at this juncture.

Striking a Balance

Bank safety-and-soundness regulation and the current deposit insurance system represent an attempt to strike the right balance among the potentially competing objectives of providing stability in the financial system, controlling moral hazard, and minimizing undue regulatory burden. The third panel considered whether the deposit insurance system currently balances these objectives appropriately, and whether adjustments are needed to ensure a proper balance going forward.

Among the topics addressed were measures that would enhance the effectiveness of the risk-based premium system. Discussion focused on ways to augment the factors that are currently used to assess premiums. Participants seemed to agree that the introduction of more market data into the assessment system might be a way to provide for more timely and accurate pricing of risks to the insurance funds, particularly with respect to large institutions. Specifically, debt ratings, yields on certain debt instruments, and measures of stock price volatility were mentioned as possible sources of information regarding risk exposure.

The impact of continued industry consolidation on the deposit insurance system was also discussed. Given that small and large institutions differ significantly in terms of activities, financial structures, geographic presence, and other characteristics, some participants expressed the view that they should be treated as distinct business types. For example, it was suggested that small, retail-oriented institutions might be subject to a higher insurance coverage limit than large, money-center banks that are less reliant on deposits for funding. The importance to small institutions of maintaining an adequate coverage limit was a recurring theme throughout the conference.

Follow-up

It seemed clear that, while support for financial modernization is widely supported, significant changes to the deposit insurance system are not. The Asian financial crisis was on the minds of many participants. Several panelists and audience members contrasted the robust state of the U.S. deposit insurance system with the inadequate and, in some cases, non-existent systems in Asia. Many expressed surprise that Americans would consider major changes to a deposit insurance system that has worked effectively.

With that in mind, however, a number of interesting ideas deserving further consideration were discussed during the day. It may be worth exploring, for example, whether the deposit insurance system is the appropriate vehicle for implementing too-big-to-fail determinations. Going forward, the FDIC will also address issues relating to differential pricing and coverage for large and small institutions, as well as the incorporation of market data and other information into the assessment system. Possible adjustments to the deposit insurance framework also will be explored, such as greater flexibility in setting assessment rates to maintain the designated reserve ratio.